PEOPLE'S REPUBLIC OF CHINA

TRADE SUMMARY

U.S. exports to China have increased nearly 77 percent since 1992, despite a 7.9 percent export decline in 1999. U.S. exports to China are dominated by higher-valued capital goods and industrial supplies, which account for some 85 percent of U.S. exports to China. The 1999 decline, in part, reflected a slowdown in China's economy. This decrease in export growth largely resulted from declines in two major sectors: aircraft and machinery. Exports to China in these categories decreased by 20 percent in 1999.

China continued to be a growing supplier of U.S. goods imports. Purchases from China increased by 14.9 percent in 1999, but accounted for only 8 percent of total U.S. goods imports in 1999. The increase in imports from China appears to be associated, in part, with the shift from elsewhere in Asia of parts of the production processes dependent on lower-skilled workers. U.S. imports from China are primarily low value-added consumer goods, such as toys, footware, apparel, and some areas of consumer electronics. Consumer goods now make up nearly 70 percent of U.S. imports from China.

As China's share of such U.S. imports has risen, that of other Asian countries has fallen, reflecting displacement by China of goods from other suppliers. For example, China's import share of U.S. imports of footwear has increased from 9 percent to 60 percent between 1989 and 1999, while the share from four Asian countries (Hong Kong, Taiwan, South Korea, and Japan) fell from a collective 51 percent to 2 percent. Similarly, for U.S. imports of toys and sporting goods, China's share increased from 22 percent to 61 percent, while the share for the four Asian countries declined from a collective 58 percent to 21 percent.

OVERVIEW

China's accession to the WTO, based on the U.S.-China bilateral market access agreement of November 15, 1999, is critical to opening China's market to U.S. goods and services. Indeed, the commitments made in the bilateral agreement would address the concerns expressed below. By encouraging structural reform and the rule of law, accession to the WTO will also support China's own domestic reform process.

The WTO Agreement builds on, but goes far beyond in the breadth and level of commitments, the fourteen trade agreements negotiated between the United States and China since 1979. These bilateral agreements included sectors ranging from civil aviation and satellite exports to agriculture and intellectual property rights protection.

The Chinese government has recognized for a number of years that economic reform and market opening are cornerstones of sustainable economic growth. Nonetheless, these reforms have been difficult for certain constituencies, particularly in the aging industrial sector and the heavily protected agricultural sector. Thus, while China today has a more open and competitive economy than 15 years ago, there are very substantial barriers in place. Government at the central, provincial, and local levels has sought to protect emerging or noncompetitive sectors from foreign competition. Resistance at the provincial and local levels of government have restricted the central government's ability to implement trade reforms, in particular with respect to intellectual property rights (IPR) protection. Import barriers, a nontransparent and inconsistent legal system, and limitations on market access combine to make it difficult for foreign firms to compete effectively in the domestic marketplace.

The Chinese Economy in 1999

China officially estimated GDP growth at 7.1 percent in 1999, continuing the gradual slowdown from the double-digit economic growth of the early 1990s. Consumer spending languished despite an ongoing infrastructure spending program and a separate social welfare benefit and civil service salary increase in mid-1999. State-owned enterprise (SOE) reform continued at a gradual pace, and layoffs contributed to a growing unemployment problem. Price deflation continued in 1999. New bank lending grew more slowly, perhaps reflecting increased prudence on the part of the dominant state-owned banks as managers were for the first time being held accountable for bad loans. The poor financial condition of the banking sector remains a major concern.

The overall economic picture is as follows: Exports rebounded from consecutive declines in the first months of the year to finish 1999 up 6.1 percent over 1998. China has maintained competitiveness in many of its major export sectors, although signs of weakness are evident in steel. Chinese imports increased by an estimated 18.2 percent in 1999, largely due to the effect of the antismuggling campaign announced in late 1998. Real import levels (allowing for the crackdown in smuggling) are widely believed to have remained stable, and may have actually declined in some sectors. Inflows of foreign direct investment slumped by 10.5 percent, year on year, through the end of October. New commitments dropped even more substantially, by 20.3 percent to $31.3 billion through the end of October.

Problems Continue Despite Progress

In an effort to cope with a slowing economy and relatively weak external demand, China continued its unilateral trade reform efforts in 1999. Some of the policies adopted will improve market access for U.S. goods and services. For example, a significant expansion in the number of firms with trading rights, reductions in the number of products subject to import quotas, and an improved system of distribution rights should benefit foreign firms. Despite this progress, measures in other areas effectively closed certain markets for imported goods and services.

In several cases, new barriers were erected. The vague wording of many Chinese laws and regulations often leads to conflicts with other laws or broader trade and investment policies, and makes compliance difficult.

Examples of Special Concern in 1999 Include:

Encryption regulations: In January 2000, the Chinese government implemented draft regulations governing the sale, distribution, use and production of commercial encryption products in China, including a ban on the sale of all foreign products. As originally proposed, the rules could have had a stifling effect on the development on the Internet and e-commerce in China and U.S. companies seeking market access. The Chinese Government, realizing the practical and commercial implications of implementing such a broad regulatory regime, recently issued a statement clarifying its commercial encryption policy. According to the March 2000 statement, the regulations will be limited to "specialized hardware and software products for which encryption and decoding operations are its core functions." Wireless phones, Windows software, and browser software are not covered. Registration requirements are also relaxed. In addition, the regulations are being researched and will be revised "in accordance with WTO regulations and promises to foreign governments." This is a positive step; the U.S. Government will continue to work with the U.S. business community to ensure that their concerns are met in future rulemakings.

Controls on social survey activities conducted by or for foreign entities: Regulations published by the State Statistical Bureau (SSB) in July 1999, require all foreign companies conducting market surveys in China to go through an annual registration process. The regulations stipulate that all survey activities undertaken by foreign institutions, or domestic agencies employed by foreigners, must first be approved by provincial statistical bureaus or the SSB. Finished survey results must also be cleared with the approving agency. The regulations will be expensive and time consuming to comply with. More important, they have the potential to limit the ability of legitimate firms to conduct market research. In addition, the potential for compromise of confidential business information is substantial.

Pharmaceutical import bans and pricing caps: The Chinese Government banned the import of nine generic medicines, including several varieties of antibiotics, pain relievers, and vitamin C, in mid-1999, in an effort to control falling prices in the domestic market. In addition, in late 1998, the Chinese government implemented price caps on pharmaceuticals, claiming it was doing so to contain health care costs.

New testing requirements for imported cosmetics: For manufactured goods, China requires quality licenses before granting import approval. Testing assesses conformity to standards and specifications often unknown or unavailable to foreigners and not applied equally to domestic products. For example, in mid-1999, the Ministry of Health imposed strict conformity assessment requirements on imports of cosmetic products containing sunscreens, skin lighteners or hair-restorers. Industry sources say the testing requirements create an effective import barrier as they are both opaque and expensive to carry out.

Restrictions on the importation of silicone structural glazing (SSG) sealant: The SSG sealant market in China is dominated by imports, estimated at $40 million annually. On July 1, 1999, the State Economic and Trade Commission (SETC) implemented a series of regulations aimed at strengthening government control over SSG sealant imports. The regulations designate a profit-seeking state-owned company, China Yuanwang Corp., as the sole import, inspection and warehousing agent for SSG sealant. In addition, import of the sealant has been restricted to five Chinese ports.

New controls on the processing industry: Regulations implemented in June 1999 further restrict the importation of certain commodities related to the processing trade. These measures are designed to shift the direction of China's processing trade toward products with higher technological content and higher value added potential. The regulations prohibit the import of used garments, certain kinds of used publications, toxic industrial waste, junk cars, used automobiles or components, seeds, seedlings, fertilizers, feed, additives, or antibiotics used in the cultivation or breeding of any export commodity. The regulations also restrict imports of plastic raw materials, raw materials for chemical fibers, cotton, cotton yarn, cotton cloth, and some steel products.

IMPORT POLICIES

China, at present, restricts imports through a variety of means, including high tariffs and taxes, non-tariff measures, trading rights restrictions, and other barriers. Prohibitively high tariffs, in combination with taxes, other import restrictions, and foreign exchange controls, form an effective firewall against many imports. Chinese officials are increasingly aware, however, that such protective measures contribute to endemic inefficiencies in the domestic economy and create an environment conducive to smuggling. To this end, the Chinese Government moved in 1999 to increase the number of firms with import/export trading rights, further reduce the number of goods subject to import quotas and licensing requirements, and cut tariffs.

As one step in the process to accede to the WTO, China concluded a bilateral market access agreement with the United States on November 15, 1999. Once it becomes a member, it must fulfill its commitments to reduce and ultimately eliminate the existing substantial barriers to access of U.S. goods and services to the Chinese market.

TARIFFS AND TAXES

Tariffs

Under the terms of the bilateral WTO Agreement, once China accedes to the WTO its industrial tariffs will fall from an overall average of about 17 percent at present to an average of 9.4 percent by 2005. Tariffs for U.S. priority agriculture products will fall from an average 31 percent to 14 percent by January 2004. In January 1999, the Minister of Finance announced tariff cuts on 1,014 products in the forestry, textile and toy sectors to set the stage for WTO accession negotiations. At present, however, high tariffs constitute an effective import barrier. In late 1999, for example, some motor vehicles faced tariffs of over 100 percent. U.S. industry points out that tariff rates for sectors in which China is trying to build international competitiveness remain especially high. As discussed below, tariff barriers are often exacerbated by non-tariff barriers that, even if tariffs are reduced, would impede imports.

Tariff rates significantly lower than the published MFN rate may be applied in the case of goods that the government has identified as necessary to the development of a key industry. This has been particularly true of high technology items. These products benefit form a government plan to increase investment in high technology manufacturing by domestic and foreign firms. Under the terms of a new foreign investment policy announced on September 8, 1999, foreign invested firms who produce certain types of high technology goods, or who are export-oriented, will no longer have to pay duty on imported equipment which is not manufactured in China and which is for the enterprise's own use. China's Customs Administration has also occasionally granted preferential tariff rates in the case of other key sectors – in particular, the automobile industry.

In August 1998, the Customs Administration launched an ambitious program to standardize enforcement of customs regulations throughout China as part of a larger campaign to combat smuggling. The program was introduced to control and ultimately eliminate "flexible" application of customs duty rates at the port of entry. While foreign businesses selling goods into China might at times benefit from lower import duty rates, lack of uniformity made it difficult to anticipate in advance what the applied duty would be.

The program successfully reduced the flexibility of local customs officials to "negotiate" duties. An 18.2 percent increase in imports, year-on-year, in 1999 is believed to be largely due to the clampdown on irregular customs practices and smuggling. On the other hand, the Chinese government has yet to seriously address the excessively high tariffs that create an environment conducive to gray market transactions and smuggling in the first place.

China is beginning to use antidumping investigations to control surges in imports of certain products. The Chinese government issued a final determination in China's first- ever antidumping case against the United States on June 3, 1999, on newsprint. China also initiated an antidumping investigation against U.S., Japanese and German manufacturers of acrylic acid products on December 10, 1999. We are looking closely at China's use of antidumping laws to ensure they are not used as barriers to trade.

Taxation

China Customs announced on January 3, 2000, that it was cutting import taxes on a number of products by as much as 2 percent, effective January 1, 2000. The cuts cover several hundred products in the textile, raw material, and production machinery and parts sectors.

Imports are sometimes subject to discriminatory application of China's valued-added tax (VAT), which ranges between 13 and 17 percent, depending on the product. While the VAT tax is collected on imports at the border, domestic producers either fail to pay the VAT or absorb the tax without passing it on to their customers and then receive loans to defray the company's losses.

Non-tariff Measures

Despite considerable progress in the 1990s, non-tariff barriers to trade and trade distorting measures persist. Non-tariff barriers (NTBS) include quotas, import licensing, import substitution and local content policies, and unnecessarily restrictive certification and quarantine standards. Trade barriers, such as export performance requirements, still distort trade. Foreign invested enterprises (FIES) continue to report being forced to accept export performance requirements in investment contracts; they say that failure to meet these requirements can result in loss of licenses for foreign exchange or contract termination. Similarly, some firms report being forced to accept contracts mandating increased "local content;" government agencies strongly encourage firms to "buy Chinese."

Non-tariff barriers to trade are primarily administered at national and subnational levels by the State Economic and Trade Commission (SETC), the State Development and Planning Commission (SDPC), the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), the Customs Administration, and the Ministry of Information Industries (MII). Specific non-tariff barriers result from complex negotiations between the central government and various ministries, state-owned corporations and trading companies.

Import Quotas

At present, quotas limit over 40 categories of commodities, including watches, automobiles, grains, edible oils, and certain textile products. The central government sets annual quotas through negotiations usually held late in each year. Officials at local and central levels evaluate the need for quantitative restrictions on particular products. Once demand has been determined, the central government allocates quota to provinces and special economic zones who distribute it to end-users. Quota amounts are often unannounced and allocation remains nontransparent to outsiders. Monopoly importers, such as exist for theatrical film imports, are able to establish *de facto* quotas which maximize their monopoly rents.

China has been gradually reducing quotas and other quantitative restrictions, but would be required to eliminate most of them only if it accedes to the WTO. Specifically, China would be required to eliminate existing quotas upon accession for the top U.S. priority products and will phase out remaining quotas, generally by 2002, but no later than 2005. Quotas will grow at an annual rate of 15 percent from levels at or above current trade.

Import Licenses

Many products that are subject to import quotas also require import licenses. Since the early 1990s, China has eliminated many import license requirements, a process that is likely to continue as preparations are made for China's WTO accession. Licenses are still required, however, for a number of items important to the United States, including grains, oilseeds and oilseed products, cotton, iron and steel products, commercial aircraft, passenger vehicles, hauling trucks, and rubber products. MOFTEC administers the licensing system, but as of late 1999 had given primary authority for approval and import of some agricultural items to the State Administration for Entry-Exit Inspection and Quarantine (SAIQ).

Although labeled "automatic," a license applicant must prove that there is "demand" for the import and that there is sufficient foreign exchange available to pay for the transaction.

Tariff-Rate Quotas

In 1996, China introduced tariff-rate quotas (TRQ) on imports of wheat, corn, rice, soybeans, cotton, barley, and vegetable oils. The regulations governing TRQ Administration have not been made public and TRQ quantities are not announced, inhibiting trade in these goods. Out-of-quota rates are currently as high as 121.6 percent. These issues were addressed in the bilateral market access agreement on China's accession. Once it accedes to the WTO, China will establish large and increasing tariff-rate quotas for these commodities, with low in-quota duties ranging from 1 to 10 percent. A portion of each TRQ will be reserved for importation through entities other than state trading entities. To maximize the likelihood that TRQs will fill, China agreed to specific rules for administration of the TRQs, including increased transparency and reallocation of unused quota to end users that have an interest in importing.

Export Licenses

Export licenses discourage foreign investment in the manufacturing sector and slow the flow of trade. On January 1, 1999, China announced that the number of products requiring export licenses had been cut from 707 to 395, a 44-percent reduction. Products still requiring licenses include raw materials, lethal chemicals and food products. Some manufactured goods – certain types of textiles, electric fans, computers, black and white televisions and bicycles – also require export licenses.

Transparency

The 1992 Bilateral Market Access MOU laid the foundation for China to improve the transparency of its trade regime. Pursuant to the agreement, China has designated the MOFTEC Gazette as the official register for publication of all laws and regulations relating to international trade. The Gazette is updated as new regulations are announced and is available on a subscription basis.

Finding information about economic and trade regulations in the print and electronic media is becoming easier. Economic newspapers now routinely carry the text of government policies and regulations. Most government ministries have also taken to publishing digests of their regulations, both in hardcopy and on their websites. The State Council and MOFTEC websites, CEI.gov.cn and MOFTEC.gov.cn, respectively, are particularly good examples of this trend. In addition, a number of commercial entities now offer databases and translations of many regulations.

Despite this progress, access to information is still a problem. Chinese ministries routinely implement policies based on "guidance" or "opinions" that are not available to foreign firms and have not always been willing to consult with Chinese and foreign industry representatives before new regulations are implemented. Experimental or informal policies and draft regulations are regarded as internal matters and access to them is tightly controlled. It can be extremely difficult to obtain copies of draft regulations, even when they have a direct effect on foreign investment. The opaque nature of customs and other government procedures also complicate the ability of businesses to take full advantage of commercial opportunities in China.

A further complicating factor is that laws and regulations in China tend to be far more general than in other countries. This allows Chinese courts to apply them flexibly, but also results in inconsistency. Companies have difficulty determining precisely whether their activities contravene a particular regulation. Agencies at all levels of government have rulemaking authority, resulting in regulations that are frequently contradictory. Finally, while there seems to be no shortage of rules and regulations, there are few procedures in place for appeal of regulatory decisions.

TRADING RIGHTS AND OTHER RESTRICTIONS

Trading Rights

China restricts the types and numbers of entities that have the legal right to engage in international trade. Only those firms with trading rights may bring goods into China. In addition, some goods such as grains, cotton, vegetable oils, petroleum and related products are imported principally through state trading enterprises.

Severe restrictions on the type and number of firms with trading rights contribute to systemic inefficiencies in the trading system and create substantial incentives to engage in smuggling and other corrupt practices. The restrictions also inhibit the ability of Chinese firms to export their products to foreign markets.

Liberalization of the trading system, which had been proceeding at a gradual pace since 1995, was given a major push in early 1999 when MOFTEC announced new guidelines allowing a wide variety of Chinese firms to register to conduct foreign trade. The guidelines allow, for the first time, both manufacturing and "nonproduction" firms with annual export volumes valued in excess of $10 million to register for trading privileges. Firms with trading rights must undergo an annual qualifications test and certification process. MOFTEC estimates that over 6,000 Chinese manufacturers, including over 200 private firms, have so far been allowed to conduct foreign trade under the new policy. MOFTEC is working on guidelines to allow foreign companies, subject to certain restrictions, to directly engage in trade.

Despite this progress, substantial restrictions remain for both domestic and foreign-invested firms. As part of its bilateral WTO accession agreement, China committed to phase out restrictions on trading rights within 3 years of its accession. This tracks with China's commitment to phase out restrictions on distribution services within 3 years of its accession.

Local Agents

The ability of foreign firms to distribute directly their products in China has been subject to strict limitations. In general, foreign firms are only allowed to distribute products that they manufacture in China. Foreign firms have been required to go through local agents to distribute imported goods. China has agreed to eliminate distribution restrictions as part of its bid to join the WTO, but the current system inhibits the ability of U.S. firms to market their products effectively.

Import Substitution Policies

Import substitution policies, imposed on both an informal and formal basis, have been a continuing problem for U.S. business. While we have seen improvement in this area since 1992, instances of apparent import substitution policies by the Chinese government continue to occur. Recent examples include:

Generic Medicines. In an effort to support falling domestic prices and further protect the domestic pharmaceutical industry, China banned the import of nine generic medicines in 1999.

Telecommunications Equipment. In late 1998, the Ministry of Information Industries (MII) issued an internal circular instructing telecommunications companies to buy components and equipment from domestic sources.

Pharmaceutical Pricing. In 1998, the State Council released regulations that implement new pricing formulas for imported pharmaceuticals based on whether domestic substitutes exist. The regulations in addition impose restrictions on profits earned on sales of imported medicines based on whether a domestic substitute exists.

Power Generation. The Chinese government announced in mid 1998 that power generation facilities of 600 MW or smaller could not use imported equipment.

Automotive Industry. The 1994 automotive industrial policy explicitly called for production of domestic automobiles and automobile parts as substitutes for imports, and established local content requirements, which forced the use of domestic products.

STANDARDS, TESTING, LABELING AND CERTIFICATION

It is often difficult to ascertain what inspection requirements apply to a particular import, as China's framework of import standards is not fully developed.
Moreover, the United States and other countries have complained that safety and inspection procedures applied to foreign products are more rigorous than those applied to domestic products. Foreign suppliers have also had difficulty in learning exactly how and who conducts inspections.

Inspection Standards

Chinese law provides that all goods subject to inspection by law or according to the terms of a contract must be inspected prior to importation.

China maintains statutory inspection requirements known as "conformity assessment procedures" on about 800 imported goods, and an even greater number of exported products. Chinese buyers or their purchase agents must register for inspection of imported goods at the port of entry. The scope of inspection includes quality, technical specifications, quantity, weight, packaging, and safety requirements.

Quality Licenses

For manufactured goods, China requires that a quality license be issued before the goods can be imported into China. Obtaining quality licenses is a time-consuming process. While requirements vary according to the product, U.S. exporters have complained that they are burdensome and contrary to principles of national treatment.

Safety Licenses

China also imposes safety licensing requirements on certain products under the terms of the "Import and Export Commodity Inspection Law" of 1989. National health and quarantine regulations in addition require that all imported (but not domestic) food items be marked with a laser sticker as evidence of the product's safety. Importers are charged between 5 and 7 cents per sticker.

Major problems with China's safety licensing system include the lack of transparency, lack of national treatment, difficulty in determining relevant standards. Examples include:

Electronic Products. On January 1, 1999 China imposed mandatory safety inspections for imports of electronic products, including personal computers, monitors, printers, switches, television sets, and stereo equipment. As of January 1, 2000, these same products require an import commodity safety license.

Cosmetic Regulations. In mid 1999, the Ministry of Health imposed strict testing standards on imports of cosmetic products containing sunscreens, skin lighteners or hair restorers. Industry sources say the testing requirements create an effective import barrier, as they require individual testing requirements for each individual product containing one of the regulated substances, making them expensive to carry out.

Phytosanitary and Veterinary Import Quarantine Standards. China's phytosanitary and veterinary import standards have a history of uneven application and are sometimes based on dubious scientific principles. In addition, standards for domestic product are either nonexistent or nontransparent.

Nonetheless, China has made substantial progress in recent years. China committed to base agricultural import standards on science. China has signed several bilateral protocols with the United States governing the import of agricultural items including live horses (September 1994); apples from Washington, Oregon and Idaho (April 1995); ostriches, bovine embryos, swine and cattle (June 1995); cherries from Washington (March 1996), bovine and swine semen (February 1997) grapes from California (May 1997), cherries from Washington, Oregon, Idaho and California (May 1998) and bovine embryos (April 1999).

As part of its bid to join the WTO, China lifted its longstanding barriers on import of U.S. grain, citrus, and meat and poultry with the signing of the Bilateral Agricultural Cooperation Agreement (ACA) in April 1999. The ban on wheat from the Pacific Northwest, for example, was imposed in 1973, over 25 years ago. These import bans severely limited access for major U.S. agricultural products, costing the United States billions of dollars in lost trade. The major provisions of the Agreement are as follows:

Meat. China agreed to recognize the U.S. certification system for meat and poultry. This means that China will accept U.S. meat and poultry from all USDA-certified plants. With China's consumption of meat and poultry growing faster than its domestic production of livestock and feed ingredients, industry analysts predict a significant increase in demand for U.S. meat and poultry in the near term.

Citrus. China lifted its ban on imports of citrus from Arizona, California, Florida, and Texas. The United States currently exports over $100 million of fresh citrus annually to Hong Kong, much of which is believed to end up in China. Removal of phytosanitary restrictions is expected to result in an increase of U.S. citrus exports directly to China, if China accedes to the WTO on the basis of the bilateral agreement negotiated in November.

Wheat. China lifted its ban on imports of U.S. wheat and other grains from the Pacific Northwest and will allow the import of U.S. wheat that is at or below a specific tolerance for TCK smut. China already purchased 50,000 metric tons of wheat in February for shipment from the Pacific Northwest per the terms of the bilateral agreement.

GOVERNMENT PROCUREMENT

Government procurement in China has been a nontransparent and noncompetitive process. Most government contracts allow for preferential treatment of domestic suppliers. Even when procurement contracts have been open to foreign bidders, such suppliers have often been discouraged from bidding by the high price that has been set on their participation. The Chinese government has routinely sought to obtain offsets from foreign bidders in the form of local content requirements, technology transfers, investment requirements, countertrade, or other concessions. In addition, payment in foreign exchange is not always guaranteed. Many Chinese officials are beginning to recognize that by not allowing an open and competitive bidding process for government contracts, China is paying too much for them.

On April 17, 1999, the State Council issued "provisional procedures for the administration of government purchases." This is China's first national law regulating government procurement practices. It is intended as an interim measure; work on a permanent law is ongoing in the Financial Committee of the National People's Congress. The "provisional procedures" are intended to establish a basic regulatory framework while work on an omnibus law continues. Officials familiar with the draft of the permanent law indicate that the financial committee has been tasked with ensuring that the provisions are WTO compatible. Incomplete reform of the state-owned sector means that preexisting regulations requiring many SOES to make purchases through specific government suppliers are still in force. These regulations will have to be revised before the permanent law can be fully consistent with WTO principles.

The interim regulations appoint the Ministry of Finance and the provincial and municipal finance bureaus as the governing agency in the administration of and supervision of government procurement. The new regulation calls on all government procurement offices to "follow the principles of openness, fairness, equality, effectiveness, and safeguarding the public interest." It establishes rudimentary criteria for the qualification of domestic and foreign suppliers and various categories of procurement, including open tenders, tenders by invitation, competitive negotiation, and sole sourcing. The regulation also sets broad standards for publicity, notification, bid scheduling, sealed bidding and bid evaluation. Existing contracts will be grandfathered under the new regulations.

As written, the provisional procedures offer insufficient protection to foreign participants in government procurement projects. Among other requirements, foreign suppliers must obtain permission from the Ministry of Finance before bidding on a project. Since there is no similar requirement for domestic suppliers, the new regulations do not provide national treatment.

EXPORT SUBSIDIES

China abolished direct subsidies for exports on January 1, 1991. Nonetheless, many of China's manufactured exports receive indirect subsidies through guaranteed provision of energy, raw materials or labor supplies. Exports of agricultural products, particularly corn and cotton, currently benefit from direct export subsidies. Indirect export subsidies are difficult to quantify since they are most often the products of internal administrative decisions and not publicized. China has agreed to stop such subsidies should it become a member of the WTO, however. Other indirect subsidies are also available, for example bank loans that effectively need not be repaid.

Export Requirements. Export requirements are imposed on state trading companies and foreign invested enterprises. This practice has tended to encourage trading companies to over-export, even doing so is not commercially viable. The ensuing financial losses are often covered by state commercial banks when loans are not repaid.

Corn Exports. China moved in 1999 to bring prices for its exported corn into line with international prices, in the process effectively eliminating a long-standing export subsidy. For example, most of China's corn exports in 1998 were sold at prices between $25 and $45 per metric ton below domestic wholesale corn prices. The elimination of this practice is in line with China's commitment to eliminate export subsidies should it become a member of the WTO.

Tax Incentives. Preferential tax incentives are another example of indirect export subsidies. China is attempting to bring a greater degree of uniformity to the system of taxes and duties it imposes on enterprises in China, domestic and foreign alike. As a result, preferential tax and duty policies that benefit exporters in special economic zones and coastal cities have been targeted for revision. Current weakness in the domestic economy has delayed some of these revisions, since the government is reluctant to impose measures that could negatively affect exports. An early 1999 experiment in eliminating certain VAT rebates for exporters located in special economic zones was abandoned after protests from domestic and foreign export firms.

INTELLECTUAL PROPERTY RIGHTS PROTECTION

Vigorous enforcement of our bilateral agreements with China has resulted in significant improvements in both intellectual property (IP) protection and market access. Before our IP agreements in 1992 and 1995, and the enforcement action in 1996, China was one of the world's largest IP pirates and a major exporter of pirated products. Today, China has improved its legal framework – and it has virtually shut down the illegal production and export of pirated music and video CDs and CD-ROMs. Indeed, today it is an importer of such products from third countries. Enforcement of intellectual property rights has become part of China's nationwide anticrime campaign and the Chinese police and court system have become actively involved in combating IPR piracy. In fact, China has been conducting a nationwide antipiracy campaign against the illegal production and trade of CDs and VCDs since October of last year that remains in effect.

Other IPR issues remain. Local and foreign intellectual property owners suffer from, for example, counterfeiting of brand name products, software piracy and, most recently, pirating of Internet domain names. While regional cooperation on enforcement of IPR has improved, it is still problematic. Difficulties with enforcement at the grassroots level include local protectionism and corruption, reluctance or inability on the part of enforcement officials to impose deterrent level penalties, and a low number of criminal prosecutions.

IPR Legislation and Administration

As a result of the 1998 government reorganization, the Chinese government established the State Intellectual Property Office (SIPO) to monitor IPR protection and devise effective enforcement measures in China. While centralizing responsibility for IPR protection is a positive step, SIPO has yet to establish that it can manage its responsibilities effectively.

One positive measure of China's commitment to strengthen IPR protections is that revisions to China's trademark law, patent law, and copyright law are currently underway. The revisions are intended to bring the laws into conformity with the Agreement on Trade Related Aspects of International Property Rights (TRIPS) and other international IPR standards covered under the World Intellectual Property Organization (WIPO) treaties.

Specific Issues

Patents and Administrative Protection: Despite the promulgation of administrative protection regulations in 1992, there have been several cases in which domestic firms are authorized to import or produce products in China before a foreign product's registration for administrative protection is complete. It can take months for an application for administrative protection of a foreign patent in China to be approved. Under regulations promulgated in 1994, domestic versions of similar pharmaceuticals can be legally registered during the period while a foreign manufacturer's application for administrative protection is pending. This allows the domestic imitation to be legally sold free of infringement liability.

Trademarks and Copyrights: While domestic copyright owners can deal directly with local copyright bureaus, foreign copyright owners wishing to pursue administratively copyright infringement issues must go through the National Copyright Administration (NCA) in Beijing. This results in lengthy delays and goes against the principal of national treatment.

A shortage of agents authorized to accept trademark applications from foreign companies makes it difficult for foreigners to register trademarks. The lack of clear procedures to protect well-known unregistered trademarks makes it extremely difficult to oppose or cancel well-known marks registered by an unauthorized party.

The software industry lacks clear procedures for addressing corporate end user software piracy. U.S. software companies have asked the NCA to issue guidelines for administrative enforcement against this problem. China's State Council, the highest executive organ of the government, issued a decree in 1999 admonishing Chinese government agencies to purchase only legal computer software. This was a very positive step. Nevertheless, end-user piracy of computer software continues to cost U.S. companies millions of dollars each year.

Regulations on the use of copyright agents by foreign companies have not yet been finalized; this effectively prevents foreign companies from using agents to register copyrights.

Domain Name Disputes: Internet domain name piracy is a relatively new IPR problem. Current standards for resolving these disputes are inadequate and need to be revised to allow for the cancellation of a pirated name.

ELECTRONIC COMMERCE

While the Chinese Government recognizes the potential of electronic commerce to promote exports and increase competitiveness, the industry is still in its infancy, but appears to be growing as the number of people with access to the Internet has grown from approximately 2 million in 1998, to 9 million in 1999, and is projected to exceed 20 million in 2000. At present, electronic commerce sales and contracts are not legally binding. Chinese ministries with responsibility for electronic commerce favor increased regulation, partially in response to the inadequacy of existing infrastructure and partially because of the Chinese Government's desire to control information exchanges via the Internet between its citizens and those of other countries. The lack of legal certainty regarding electronic transactions and related security issues pose significant challenges to the development of electronic commerce in China.

In 1996, the Chinese Government established the China International Electronic Commerce Center (CIECC). A division of the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), CIECC provides various electronic commerce services to Chinese enterprises and institutions in order to promote foreign trade. Due to an underdeveloped Internet infrastructure, a low subscriber base, and inadequate payment/credit systems, however, the more rigid electronic data interchange (EDI) based electronic commerce remains the dominant format in China. EDI functions like a club, with member firms paying fees to use the standardized forms and dedicated networks that manage information transactions.

Electronic commerce services are beginning to develop in China. In 1999, a number of on-line stores were introduced in China. Many restaurants, bakeries and other service outlets now allow patrons to place orders on-line for delivery. A number of problems inhibit the growth of the industry, however. Regulatory standards on electronic commerce have not been published and remain unclear. High connection rates charged by Internet service providers, who are currently far above internationally competitive rates, make Internet access unaffordable for most Chinese. Slow connection speeds are another major barrier. Finally, the lack of a safe and secure payment system requires that Internet transactions in China be conducted on a cash-on-delivery basis or delayed by a ten-to fifteen-day verification period.

SERVICES BARRIERS

China's services sector has been one of the most heavily regulated parts of the national economy – and one of the most protected. The service commitments included in the bilateral WTO accession agreement would provide meaningful access of foreign businesses to the full range of services sectors, and addresses the barriers identified below. The Chinese economy itself will benefit from the increased scope of services, and the professionalism and technical expertise that U.S. service providers will bring. There will be substantial efficiency gains to the domestic economy as well from increased foreign participation in financial, insurance, telecommunications, retail, distribution and professional services, after sales service and repair businesses.

At present, foreign service providers are largely restricted to operations under the terms of selective "experimental" licenses. The strict operational limits on forms of establishment for entry, and restrictions on the geographic scope of activities, severely limit the growth and profitability of these operations.

Since China's services sector remains underdeveloped and current foreign participation in the market is minimal, it is difficult to estimate how much such barriers to market access represent in lost U.S. exports of services. In some service sectors, such as insurance, even the most conservative estimates predict that total premiums will reach $15 - 30 billion in the next few years. If China were to lift completely barriers to market access in this sector, U.S. industry estimates that U.S. insurance providers could be expected to capture a portion of the Chinese market that could easily exceed $1-2 billion. In other services sectors, such as legal services, accountancy, and consulting, and where potential revenues are likely to be more modest, the lifting of barriers to market access would still result in significant increases in U.S. exports of services.

Financial Services (Banking and Securities)

Foreign banks are subject to a restrictive, non-transparent regulatory environment. Some progress has been made in the last year, but the market access of foreign banks and securities firms is still inadequate and largely unprofitable. Foreign securities firms continue to be barred from underwriting or trading domestic stocks or bonds. This has negatively affected the investment environment.

Events of significance in 1999 include the relaxation of restrictions on local currency business. Local currency licenses have been issued to banks in Shanghai and Shenzhen, and extension of this experiment to other cities such as Tianjin is planned. The geographic limits on the local currency business of foreign bank branches in Shanghai have been widened to include neighboring Zhejiang and Jiangsu. Local banks are now permitted to lend medium-term renminbi funds to foreign banks, and the central bank conducted the first rediscount transaction with a foreign bank. Despite these improvements, foreign banks are still restricted to taking local currency deposits from, and making local currency loans to, foreign investors registered in the specified geographic area.

Distribution

Distribution in China is largely reserved for domestic companies. Existing restrictions on distribution services limit the ability of foreign firms and importers to service and support their customers. In general, foreign importers have limited trading rights, cannot own or operate trucks or warehouses, and must sell and distribute their goods through state-sanctioned foreign trade corporations or import-export agents, who often impose huge markups on the final price.

Consolidation: Current law prohibits foreign companies with multiple operations in China from consolidating shipping and other distribution-related activities. Domestically manufactured products must be sold, delivered and serviced separately from imported products. These regulations prevent foreign enterprises from selling products from other domestic sources, even when the products concerned are related. These requirements create redundant systems and increase costs for foreign firms.

Retailing

Regulations broadening the scope for foreign investment in the retail sector were announced in June 1999. Aimed at encouraging the development of large retail chain stores along the Wal-Mart model, and said to be intended as a solution to the moribund condition of many state-owned department stores, these regulations encourage the entry of large international retailers into the Chinese market.

The regulations require foreign investors to have maintained an average annual volume of merchandise sales of at least $2 billion during the three years prior to the application for permission to operate in the Chinese market, in addition to having $200 million in assets. These requirements effectively eliminate medium and small sized retailers from participation in the Chinese market. The regulations require chain stores with fewer than three outlets to have minimum local equity ownership of 35 percent, chains with more than three outlets are required to have local equity ownership of no less than 51 percent.

Direct Sales: Pyramid schemes operated by a number of direct sales companies, both domestic and foreign, led to a government ban in 1998 on this type of retailing in China. This severely affected several legitimate U.S. companies that had put substantial investment into this sector in the early 1990s.

Telecommunications

National security concerns and protection of the monopoly rents of domestic industries have restricted the opening of China's domestic telecommunications services market. In addition, the lack of a telecommunications law has left both foreign and domestic companies vulnerable to inconsistent application of and changes to regulatory policies. For example, the Ministry of Information Industries (MII) move in 1999 to cancel contracts signed under an experimental joint venture formula ended the only acceptable means of foreign participation in China's telecommunications services market.

Internet Services: Development of China's Internet services market has been hurt by high connection costs and other problems. In addition, a state council directive published in mid 1999, bans cable networks from offering telecommunications services, including Internet access, and telecommunications providers from offering television broadcasting services.

Insurance Services

The need for a sound regulatory environment and improved solvency among insurance firms has led to gradual reforms in China's insurance industry. The Chinese Government passed a new insurance law in 1993 and formed the China Insurance Regulatory Commission in 1998 to oversee the development of the industry in China. The domestic insurance market was opened on an experimental basis to foreign insurers in 1992. Currently, 13 foreign insurers are licensed to operate in Shanghai or Guangzhou. The scope of business remains severely limited. Foreign insurers are at present not permitted to participate in the group, health, pension, and insurance brokerage markets.

Further opening of the insurance industry in China will be a key part of China's continued economic development. The domestic market currently lacks sufficient capital in the reinsurance and brokerage sector to spread risks generally and to ensure coverage for high-risk exposures such as space launches and spread risk. The success of reforms in China's state-owned sector will be dependent to some extent on the availability of solvent pension, medical, and life insurance services.

Audiovisual Services

Chinese Government concerns about the entry of politically sensitive materials into China have led to restrictions in audiovisual services. The websites of foreign news organizations are often blocked for extended periods of time, and news services must remain wary that new restrictions could be imposed on their activities. Distribution of sound recordings, videos, movies, books, and magazines is highly restricted. Inconsistent and subjective application of censorship regulations act as a further impediment to the growth of the market for foreign and domestic providers alike.

Legal Services

One of the cornerstones of China's reform process is the introduction of policies that support the principle of rule of law. The Chinese Government has made a concerted effort to modernize the existing legal infrastructure in China but there are still acute shortages of lawyers and judges.

Foreign law firms have largely been excluded from entering China's legal services sector. China has permitted the establishment of foreign law firms in designated cities on a case-by-case basis only. Foreign law firms are permitted to practice in one city only and are not permitted to hire Chinese nationals to practice law. Chinese law firms, on the other hand, have been able to open offices freely throughout China since 1996. Foreign attorneys have so far not been allowed to take China's bar examination necessary for licensing to practice law in China.

Accounting Services

Accounting standards in China are not consistent with internationally accepted practices, nor are existing standards uniformly applied. The quality of accounting reports produced in China is often far below the internationally accepted norm. In an effort to improve the situation, the Chinese Government has moved to close substandard firms and reexamine existing licensing procedures.

Foreign accounting firms wishing to provide the full range of accounting services in China have been required to partner with domestic firms. Foreign firms have complained that these joint ventures, in which they have not been permitted to take a majority share, are often not managed to international standards. In addition, representative offices of foreign accounting firms have been limited to providing consultancy services.

Travel and Tourism Services

At present, foreign travel and tourism service providers are prohibited from providing full-service travel agencies in China. Permitted activities are subject to geographic restrictions. There are also a number of restrictions in place regarding the hiring of guides and tourist agents.

Other Professional Services

U.S. engineers, architects and consultancy services have enjoyed a relatively more cooperative and open relationship with the Chinese Government. These professions operate in the Chinese market through joint venture arrangements and are less affected by regulatory problems than other service sectors.

INVESTMENT BARRIERS

Despite the ongoing commitment of the leadership to "further opening" to investment, foreign investment inflows are strictly controlled and channeled toward areas that support national development objectives. China encourages foreign investment in priority infrastructure sectors such as energy production, communications, agriculture, forestry, environmental protection, and transportation, and restricts or prohibits it in sectors such as telecommunications, where there is a desire to protect a domestic industry.

For the past six years, China has been the second largest recipient of FDI in the world, after the United States. According to Chinese statistics, utilized FDI in China since 1979 reached a cumulative total of just over $267 billion by the end of 1998, with over $45 billion that year, roughly the same as in 1997.

There are signs, however, that the rapidly increasing FDI inflows of recent years are slowing. The total value of newly pledged foreign investment contracts dropped in the first three quarters of 1999; actual FDI inflows decreased as well. The number of new projects has also declined significantly, although this has been partially offset by the increase in the size of new ventures. The Asian financial crisis is partly responsible for the slowdown, as investment from other Asian countries and overseas Chinese has fallen.

Chinese Government officials acknowledged in late 1999 that the strict regulation of foreign business activities, particularly in the service sector, had contributed to sliding foreign investment volumes. In July 1999, MOFTEC said that multinational conglomerates were shying away from the China market because "China still was not satisfying the (market access) conditions in the financial, telecommunications, insurance and other service sectors" needed to attract these firms.

Investment Guidelines

In an effort to further encourage inward flows of foreign investment, China has adjusted its investment guidelines a number of times over the last five years. The revisions have created confusion among potential investors and added to the perception that the investment guidelines lack transparency. Uncertainty as to which industries are being promoted as investment targets, and how long such designations will be valid, undermines confidence in the investment climate.

Nonetheless, China has taken some positive steps. The government announced a series of measures in August of 1999 that begin to decentralize investment approval decision-making authority and create new incentives for investments in key sectors and geographic regions. Among other improvements, the new guidelines allow authorities at the provincial level of government to approve "encouraged" foreign-invested projects.

Investment Restrictions

The Chinese Government places great emphasis on guiding new foreign investment toward "encouraged" industries and areas. Over the past four years, China has implemented new policies introducing further incentives for investments in high technology industries and in the central and western parts of the country in order to stimulate development in remote areas. At the same time, the government prohibits or restricts foreign investment in projects not in line with the state plan. There are, in addition, a number of sectors in which foreign investment is technically allowed, but not "encouraged." Restricted categories generally reflect:

- The protection of domestic industries, such as the service sector, in which China fears its domestic market would quickly be dominated by foreign firms;

- The goal of limiting imports of luxury products, requiring high volume imports of components or raw materials; and

- The avoidance of redundancy or excess capacity.

There are numerous examples of investment restrictions. For example, China bans investment in many telecommunications services, as well as in the news media, broadcast, and television sectors, citing national security interests. In addition, China restricts investment in much of the rest of the service sector, including distribution, construction, tourism and travel, shipping, advertising, legal services, and others. In many cases foreign firms must form a joint venture with a Chinese company, and restrict their equity ownership to a minority share, in order to invest in the China market. Finally, local content and other performance requirements in contracts inhibit investment into China.

Other Investment Issues

Designated Enterprises: Designation of key state enterprises in many industries, in particular the high technology sector, as the exclusive base for the development of critical technologies, limits the choice of joint venture partners. Such designated partners are sometimes unattractive for various business reasons such as lack or experience, inappropriate staffing levels, or weak finances.

Legal Arbitration: For many companies, the highly personalized nature of business in China often makes arbitration or other legal remedies impractical. Even when they have strong cases, foreign investors often decide against using arbitration or other legal means to resolve problems out of concern over permanently alienating critical business associates or government authorities.

ANTI-COMPETITIVE PRACTICES

Anti-competitive practices in China exist in the form of monopolistic or monopsonistic practices designed to protect the state-owned sector. In some cases, industrial conglomerates operating as monopolies or near monopolies (such as China telecom) have been authorized to fix prices, allocate contracts, and in other ways restrict competition among domestic and foreign suppliers. Such practices may restrict market access for certain imported products, raise production costs, and restrict market opportunities for foreign investors in China.

OTHER BARRIERS

Legal Framework

The lack of a clear and consistent framework of laws and regulations is an effective barrier to the participation of foreign firms in the domestic market. Although China is moving toward a commercial rule of law, many gaps exist. A comprehensive legal framework, coupled with adequate prior notice of proposed changes to laws and regulations, and an opportunity to comment on those changes, greatly enhances business conditions, promotes commerce, and reduces opportunities for corruption.

In China, laws are promulgated by a host of different ministries and governments at the provincial and local levels, as well as by the National People's Congress. As a result, regulations are frequently at odds with each other. Even though laws and regulations are now routinely published in China, they often leave room for discretionary application – either through honest misunderstanding or through selective application – or are ignored outright. Officials have sometimes selectively applied regulations against foreign firms.

Dispute Resolution

Skepticism about the independence and professionalism of China's court system and the enforceability of court judgements and awards remains high in the international community.

This has often caused both foreign and domestic companies to avoid enforcement actions through the Chinese courts. The Chinese Government is moving to establish consistent and reliable mechanisms for dispute resolution through the adoption of improved codes of ethics for lawyers and judges and increased emphasis on the consistent and predictable application of laws. The China International Economic and Trade Arbitration Commission (CIETAC) has become, over a short time frame, an effective forum for the arbitration of trade disputes. CIETAC's policies that approve foreign professionals to act as arbitrators, and streamline procedural requirements to allow for timely resolution of disputes have been well received by the foreign business community. The business community continues to press, however, for improvements in CIETAC rules, including increased flexibility in choosing arbitrators, and enhanced procedural rules to ensure orderly and fair management of cases.

Labor and Benefits

The Chinese Government is in the process of developing a nationwide uniform social insurance, medical insurance and pension system. At present, however, the cost of such benefits packages varies widely as existing standards and taxes are unevenly applied, depending on the enterprise or jurisdiction. This lack of uniformity and transparency creates problems for foreign investors. In addition, while average wages in China remain extremely low, the cost of employees in the large coastal cities where most foreign businesses are required to operate is among the highest in Asia. Expensive mandatory benefits and subsidies put the cost of labor for workers and professional staff in these cities above that of similar employees in Malaysia, Thailand, the Philippines, Vietnam, and Indonesia. The situation is complicated by restrictions on the movement of Chinese staff between locations in China.

Corruption

Despite the promulgation of China's first law on unfair competition in December 1993, official corruption remains widespread. The government continues to call for improved self discipline and anticorruption initiatives at all levels of government. However, it remains the case that contracts are often not awarded solely on the basis of commercial criteria. U.S. suppliers complain that the widespread existence of such practices in China puts them at a competitive disadvantage. While this dilemma is less severe in sectors where the United States holds clear technological preeminence or cost advantages, corruption does undermine the long-term competitiveness of both foreign and domestic entities in the Chinese market.

Smuggling

China's Customs General Administration announced an anti-smuggling campaign in late 1998. The campaign has reduced trade through black and gray market channels and resulted in an increase in imports through legitimate channels. It did not, however, address the tariff and non tariff barriers that created an environment conducive to smuggling in the first place. Further, in an effort to control illegal foreign exchange transactions and prevent capital flight, the state administration of foreign exchange announced regulations in late 1998 that place strict controls on foreign exchange transactions by foreign-invested firms.